

market share is one of the factors cited.⁵⁴ Indeed, Schmalensee and Taylor do not argue, as does USTA's other expert, Dr. Harris, that "the Commission should not use market share as a measure of market power."⁵⁵ Rather, Schmalensee and Taylor argue that "market share cannot be taken in isolation and used to determine the degree to which a market is competitive."⁵⁶ Time Warner does not disagree with this particular statement and indeed has not proposed criteria that would look at market share "in isolation."

The Department of Justice Merger Guidelines cited by Schmalensee and Taylor in support of addressability indicate a market share of 35 percent as the "standard of dominance."⁵⁷ Although Schmalensee and Taylor dispute that the 35 percent level should apply to LECs in the access market, the DOJ Merger Guidelines they cite to without criticism use a "standard of dominance" that is based on the structural measure of market

⁵⁴ In its Position Paper (Attachment 9) at 6, USTA misrepresents the economic literature cited by Schmalensee and Taylor at 33. According to the USTA Position Paper, "The degree of market power possessed by the incumbent firm is given by the elasticity of demand for that firm's products" and that "This firm elasticity has two components"... the elasticity of the final demand for the services... and the elasticity of substitution." USTA conveniently (and quite erroneously) fails to identify the third component of the firm price elasticity of demand, which as clearly acknowledged by Schmalensee and Taylor at p. 33, is in fact the market share of the incumbent firm. USTA's misrepresentation of the economic literature leads it to conclude quite falsely that "What begins as a question of demand elasticity therefore becomes a question of the availability of alternative sources of supply." USTA Position Paper at 6. An accurate conclusion would be that what begins as a question of demand elasticity facing the incumbent firm becomes a question of the availability of alternative sources of supply, the demand elasticity facing the market as whole, *and the market share of the incumbent firm*. See the landmark article, which Schmalensee and Taylor cite, in footnote 40 of their paper, "Market Power in Antitrust Cases," *supra*.

⁵⁵ Harris, p.29.

⁵⁶ *Id.*

⁵⁷ Schmalensee and Taylor at 33.

share, and not merely the "availability of competitive alternatives."⁵⁸ Similarly, the standard of market power embodied in the Cable Act of 1992 and cited by Schmalensee and Taylor does not support the concept of addressability as proposed by USTA. Schmalensee and Taylor are not technically wrong in stating that the standard of market power embodied in the Cable Act of 1992 includes an availability criterion. However, the particular requirement under the Cable Act of 1992 is that a competitor must offer service to *at least 50 percent* of the households in the franchise area, in contrast to USTA's proposal which would require a competitor to offer service to as few as *one* of the customers in the LEC's serving area. Moreover, the Cable Act of 1992 — like most other proposed and enacted legislation involving competitive criteria⁵⁹ and unlike USTA's proposed addressability standard — also includes a market share requirement.

C. Addressability in a wire center is not sufficient to prevent LECs from engaging in anticompetitive behavior.

As Drs. Schmalensee and Taylor so openly acknowledge, "the pricing flexibility requested in a CMA could — in principle — lead to higher profits and prices through the exercise of market power."⁶⁰ Drs. Schmalensee and Taylor attempt to dismiss the potential of LECs to engage in anticompetitive behavior in a CMA, but their arguments are wholly unpersuasive.

First, Schmalensee and Taylor argue "there is no magic formula that provides a

⁵⁸ *Id.*, pp. 32-33.

⁵⁹ *See, e.g.*, Utah Code Ann. at 54-8b-3 (1991); Colorado Revised Statutes 40-15-207 (1990); Wis. Stat. at 196.195 (1989-1990); Revised Code of Washington 80.36.320 (1990); and Minn. Stat. at 237.59 (1990).

⁶⁰Schmalensee and Taylor, p.32.

structural indicator that could signal when market power was a threat and when it was not."⁶¹ Yet, the fact that there may be no one "magic formula" does not provide support for a standard, such as addressability, that ignores the most important structural indicator, i.e., market share. Indeed, as discussed above, in comparison to the other standards relied upon in various regulatory, legislative, and judicial forums, including those *specifically identified* by Drs. Schmalensee and Taylor, addressability is a weak and unsupported approach to measuring LEC market power. In particular, the addressability standard would permit a wire center to be classified as a competitive market area or CMA, even though the overwhelming majority of customers within that wire center did not face realistic competitive alternatives.

Second, Schmalensee and Taylor argue that since prices and quantities in a CMA would be removed from price cap regulation, and there would be no change in price limits in less-competitive wire centers, there would be no opportunity for LECs to make up lost revenues resulting from price reductions in a CMA by increasing prices in the less-competitive wire centers.⁶² This argument conveniently ignores the ability of LECs to exercise market power in *non-competitive sectors within a CMA*. Such a strategy would be entirely possible under the weak standard of addressability proposed by USTA, which as noted above, would classify a wire center as competitive, even though the majority of customers did not have viable competitive alternatives to the LEC. Moreover, a LEC strategy of engaging in monopolistic price increases in non-competitive sectors of the CMA to compensate for price reductions within that CMA would be facilitated by strategic definitions of a wire center to include outlying rural/suburban areas served by remote serving units in the same wire center as the central urban area in which the host switch resides.

⁶¹*Id.* at 38.

⁶²*Id.* at 39.

In summary, addressability fails to live up to the claims made by USTA and its experts. As discussed above, addressability is not supported as a measure of market power by economic theory, by the Department of Justice (DOJ) Merger Guidelines, or by the Cable Act of 1992. Nor is addressability "conservative,"⁶³ unless perhaps it is being compared to the largely discredited contestability theory, and even that would not be true if the LECs are allowed to use wire center land area as a surrogate for demand for alternative suppliers. Nor can it reasonably be argued that addressability is the "simplest and most direct indicator of market power,"⁶⁴ first because addressability is not established as an indicator of market power, or of much else, for that matter, and second, because the simplicity of the concept results only if one relies on totally inappropriate "surrogates" for measuring demand for alternative suppliers. Finally, addressability is neither "practical" nor "workable,"⁶⁵ given the informational requirements that would have to be imposed on emerging, nondominant alternative suppliers, as well as the proposed reliance on customer affidavits, requests for proposals, and surveys.

D. The transaction based analysis proposed by ALTS provides a useful construct to *complement* the fundamental S-C-P paradigm.

ALTS proposes that the Commission rely on a "transaction based analysis" based upon the "New Institutional Economics" developed by Professor Oliver Williamson.⁶⁶ Time Warner agrees with ALTS regarding the value of "off-line, shirt-sleeves negotiation" in terms of the objective of "producing a workable set of definitions of the elements of access

⁶³ See claim made in USTA Position Paper at 12.

⁶⁴ See claim made in USTA Position Paper at 15.

⁶⁵ See claim made in USTA Position Paper at 17.

⁶⁶ ALTS Comments at iii.

necessary for the development of a competitive local exchange market."⁶⁷ The "transaction based analysis" approach complements (as opposed to being a substitute for) the establishment of competitive criteria for price cap LECs based upon the Structure-Conduct-Performance Paradigm. Indeed, the paper by Jerry Duvall and John Williams ("Guidelines for Designing Federal Regulatory Policy to Promote Competitive Local Telecommunications Services") which provides the basis for the ALTS position (and is attached to the ALTS Comments) supports this view.⁶⁸

V. Modifications to the LEC Price Cap Plan

Time Warner did not comment specifically on the baseline issues of the Notice in its initial comments, and will not cover them in detail in this reply. However, it must be noted that the vast majority of non-LEC parties have called for revisions in the price cap parameters to achieve a more equitable allocation of benefits between LEC ratepayers and LEC shareholders, including (a) a higher productivity factor, (b) a narrower allowance for exogenous costs, (c) continuing earnings sharing, possibly with a lower threshold earnings level, and (d) lowering of rates and/or the benchmark rate of return to reflect the longstanding decrease in the LECs' capital costs.⁶⁹ The LECs, in contrast, want all aspects of the price cap that require a determination of their rate of return to be eliminated, including

⁶⁷ See ALTS Comments at 11.

⁶⁸ Compare Duvall and Williams at iii ("Application of economic concepts developed within the literature of the New Institutional Economics, specifically the economics of property rights and transaction cost economics, *complements* the structure-conduct-performance paradigm as a method for assessing the extent of competition...." [emphasis added]) with ALTS Comments at iii.

⁶⁹ See, e.g., AT&T Comments at iii-v; Ad Hoc Committee Comments at 5, 18, 24-25; MCI Comments at 6-7; Ohio Office of Consumers' Counsel at 7-10; ICA Comments at 1-2.

sharing and the low-end adjustment, along with depreciation prescription. They also propose a lower productivity factor and argue against a more restrictive treatment of exogenous costs.

In evaluating the arguments raised by the parties, the Commission should bear in mind that the effect of an overly generous price adjustment formula goes beyond the immediate harm done by depriving consumers of just and reasonable rates (including their intended share of the benefits of incentive regulation). The revision of price cap formulas to generate even higher profit levels (at the expense of captive ratepayers) would chill emerging competition in local exchange and access services, by infusing the LECs with additional capital to invest in those markets (regardless of the actual efficiency of such investment). In particular, the Commission would be ill-advised, at this time, to accept the LECs' arguments that their earnings should no longer be of any consequence in the ratemaking process and that their depreciation practices should no longer be subject to scrutiny by the Commission.

A cornerstone of the LECs' full frontal assault on the Commission's price cap regulation is their insistence that earnings sharing be eliminated.⁷⁰ The LECs portray sharing as inconsistent with the "spirit" of price caps and a fundamental disincentive to increased efficiency and investment by the LECs.⁷¹ The LECs maintain that whatever rationale existed in the original LEC price cap plan for a sharing mechanism is obsolete, now that the price cap mechanism has been tested and proven effective.

According to the LECs, the FCC's decision to include a sharing mechanism in the initial price cap plan was merely a temporary expedient, which was always intended to expire once the Commission obtained some experience with the price cap mechanism generally and

⁷⁰ See, e.g., USTA Comments at 7-9, 45-52; Pacific/Nevada Bell Comments at 43-44; Bell Atlantic Comments at 43-47.

⁷¹ See, e.g., USTA Comments at 8; Ameritech Comments at 14; BellSouth Comments at 50-51.

with the productivity factor in particular.⁷² The LECs' reading of the FCC's initial *Price Cap Decision* is artificially narrow and mischaracterizes the FCC's policy. While the FCC did refer to sharing as a "backstop" mechanism, the function of that backstop was not as limited as the LECs now suggest. The Commission said:

In fashioning the backstop plan for LEC price caps, we have sought to balance competing goals. On the one hand, the benefits of increased productivity promised by the price cap program depend upon the creation of new profit incentives for the LECs. A backstop mechanism may dampen the LECs' risks and rewards and thus reduce the incentives of a "pure" price cap plan. On the other hand, any price cap plan must be consistent with the Communications Act, assuring just and reasonable rates and the continued availability of quality services. A backstop mechanism can help ensure that the plan fairly shares the risks and rewards of future productivity gains between the LECs and customers, even in the unpredictable and varying circumstances of future years.⁷³

There is nothing temporary about this conclusion. The LECs see only one side of the *balance* constructed by the Commission — the fact that they are not free to retain *all* of the profits they derive under the price cap plan. The purpose of the other side of the *balance* is to (1) allow ratepayers to benefit directly from efficiency gains stimulated by alternative regulation, and (2) reduce potential errors in setting the productivity factor that would otherwise result in excess monopolistic earnings being retained by the LECs.⁷⁴ Despite the LECs' complaints (and most are simply repetition of arguments raised during the Commission's initial price cap proceeding), sharing is an integral part of the appropriate balancing of interests achieved under the price cap form of incentive regulation and is necessary to fulfill the Commission's responsibilities, under the Communications Act, to

⁷² See, e.g., GTE Comments at 67-68; BellSouth Comments at 49-52; Ameritech Comments at 14-15.

⁷³ *LEC Price Cap Order* at para. 121.

⁷⁴ Ad Hoc Committee Comments at 71.

assure just and reasonable rates. Moreover, the Commission's experience with LEC price caps does not ensure that the revised productivity offset selected in this proceeding will be both flawless and timeless.⁷⁵

The LECs also imply that the form of "pure" price cap regulation applied by the Commission to AT&T is a logical next step for LEC regulation⁷⁶ — as though there was a natural entitlement to "*graduate*" to the next level of deregulation. The difference between the level of competition faced by AT&T and that confronting the LECs is obvious: by the time AT&T was given the degree of regulatory flexibility demanded by the LECs, its market share had fallen below 70%. LEC market shares are still in the 99% range.

The LECs argue that earnings sharing "dampens" their incentives to efficiency and makes them less attractive to investors.⁷⁷ The Darby study, attached to the comments of USTA and referenced by several of the LECs, contains quotes from various members of the financial community suggesting that the LECs would be better investments if earnings sharing were eliminated.⁷⁸ It goes without saying that LEC investors would be enthusiastic about the prospect of unconstrained monopoly profits, but such excesses are neither in ratepayers' interests nor lawful under the Communications Act. In a competitive market, the

⁷⁵ While the Commission also said that it *might* be possible to eliminate "the automatic stabilizer" should experience with the price cap plan increase the Commission's confidence in the details of the plan, including its ability to set a productivity factor that would reflect "a reasonable estimate of projected productivity growth," the Commission did not predict or promise that the experience obtained prior to the first price cap review would justify such a change.

⁷⁶ See USTA Comments at 10-11.

⁷⁷ See, e.g., USTA Comments at 22; Southwestern Bell Comments at 44; Ameritech Comments at 4.

⁷⁸ USTA Comments, Attachment 3, Larry A. Darby, "Price Cap Reform, Financial Incentives and Exchange Carrier Investment", pp. 19-21.

LECs would have no regulatory constraint on profits, but the market itself — not regulators — would be there to set a limit on their earnings. So long as price cap regulation stands in the place of competition, it retains a legitimate basis to constrain absolute monopoly profits. Finally, the LECs argue that sharing unnecessarily complicates price cap regulation and maintains a level of regulatory burden for both the Commission and the LECs that is inconsistent with the objectives of alternative regulation. Again the LECs oversimplify the issue. In fact, the Commission saves regulatory effort elsewhere in its price cap regime as a result of the "backstop" function performed by the sharing mechanism. Without the sharing mechanism, the burden of proof on the LECs with regard the productivity factor, and other price cap formula inputs, such as exogenous factors, would have to be much greater before the Commission could have confidence that the resulting rates were just and reasonable. More importantly, while it is a valid regulatory objective to seek an alternative form of regulation that is simpler than rate of return regulation, this goal should not be elevated at the expense of effective regulation.

VI. Conclusion

The Commission has set itself the commendable objective of guiding the telecommunications industry toward growth, efficiency and innovation in a *competitive* environment. The path to attaining this objective lies primarily outside of this proceeding, in the Commission's initiatives to establish the essential conditions in which competition can develop. Within the context of this LEC Price Cap Review, the Commission can best

advance the long-run attainment of competition by not prematurely dismantling the effective regulatory safeguards against the LECs' abuse of their still-substantial market power.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, David R. Poe, hereby certify that I have this 29th day of June, 1994,
mailed, via first-class, postage pre-paid, a copy of the foregoing **REPLY COMMENTS OF
TIME WARNER COMMUNICATIONS** to the attached service list.

A handwritten signature in black ink, appearing to read 'David R. Poe', with a long horizontal stroke extending to the right.

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